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Tuesday, October 20, 2009

Non-market but voluntary economic institutions

Often in political parlance the phrase "the market" is used quite broadly to cover a wide variety of voluntary economic institutions, including firms, non-profit organizations, families, and so on in addition to markets proper. But traditional neoclassical economics is about ideal markets proper: instantaneous buying and selling on a costless spot exchange. Ronald Coase started expanding the scope of economics with his work on the firm, and this line of thinking has developed into a school, often called the "new institutional economics" or NIE that focuses on non-market or partial-market voluntary economic institutions as well as on the conditions that must be satisfied for efficient markets to be possible. The economics Nobel committee has finally recognized the study of non-market but voluntary economic institutions with its awards this year to Oliver Williamson and Elinor Ostrom.

Williamson and his fellow travelers Oliver Hart, Yoram Barzel, Steven Cheung, and Janet Landa have long influenced my thinking about measuring value, mental transaction costs, smart contracts, the origins of money, and more.

The new institutional economics school in a nutshell holds that often transaction costs are too high for spot markets to work properly. If spot markets were perfectly efficient we would not need firms or long-term contracts, for example, but in fact we have those and many other institutions besides pure markets. The NIE studies and has started to explain the functions of institutions that are not markets proper, such as long-term contracts and firms, as well as the legal underpinnings of market economies, especially property and contracts. Contracts and property are the main formal expressions of economic relations recognized by the NIE, which makes this school especially interesting to someone like me interested in the economic role of contracts and property and how to adapt these institutions to (and even to some extent incorporate them into) evolving technology.

Note that these institutions are "voluntary" in the sense of the traditional common-law principle of non-initiation of force, and assume a sophisticated legal framework. When this assumption doesn't hold, these principles usually work in a very different way or don't work at all, and one has to be very careful applying them. (See here and here for more on the problem of coercive externalities).

Meanwhile, here is a good article introducing the other economics Nobel winner this year, Elinor Ostrom.

Posted by Nick Szabo at 3:45 PM

Pages

- Home

About Me

Nick Szabo

"A premier thinker about history, law and economics, and the lessons they have for security." -- Adam Shostack, Emergent Chaos

"Szabo comes out with these essays that leave me in awe." -- Brian Dunbar

"Reading material that is eclectic, challenging and endlessly fascinating." -- Sean McGrath, Propylon

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4 comments:

nazgulnarsil said...

long term contracts are needed primarily because of uncertainty about actors that can afford to remain irrational indefinitely i.e. government. you can assume that other market actors will approximate rationality or fail. if not for this, rapid changes in technology (leading to rapid unexpected changes in consumer preference) would make long-term contracts silly. taken this way, a long term contract is an attempt to mitigate rising transaction costs that arise because the future is being made more uncertain than it needs to be, forcing you to distribute resources in a way that will allow your survival given a wide range of future conditions.

10:38 AM

nazgulnarsil said...

come to think of it that doesn't only hold for government but for large failing corporations that do business with smaller businesses. the small business has to assume that the larger business can stay irrational longer than the small business can stay liquid.

10:40 AM

nick said...

Coercive actors and irrational acts of large organizations important, but hardly the only, causes of uncertainty, and uncertainty is only one of the motivations for long-term contracts (temporal preferences for spending, e.g. for capital investment, are another).

3:31 PM

Anonymous said...

nice post. thanks.

1:08 AM

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- ► 2018 (1)
- ► 2017 (3)
- ► 2016 (4)
- ► 2015 (3)
- ► 2014 (3)
- ► 2013 (3)
- ► 2012 (8)
- ► 2011 (12)
- ► 2010 (9)
- ▼ 2009 (29)
  - ► November (3)
  - ▼ October (6)
    - Incentives
    - Our great...grandmother was a proton-powered rock
    - Non-market but voluntary economic institutions
    - How to save yourself from chasing futuristic red h...
    - The tax collector's problem
    - When does citizen's arrest become battery?
  - ► September (3)
  - ► August (1)
  - ► July (1)
  - ► June (3)
  - ► May (6)
  - ► April (3)
  - ► January (3)
- ► 2008 (55)
- ► 2007 (47)
- ► 2006 (130)
- ► 2005 (44)

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